October 2012

"It's déjà vu all over again" - Yogi Berra

Dear Client,

The global news cycle has been stuck on "replay": Greece on the verge of exit from the Euro, rescued yet again by last minute concessions; Euro members close in on an all encompassing solution, only for it to fall short; U.S. congress plays a game of chicken over fiscal policy - last year the "debt ceiling," this year the "fiscal cliff"; another round of QE by the Fed; further IMF cuts to growth forecasts; and ongoing equity market volatility as sentiment ebbs and flows.

The list goes on.

We are lurching from one potential crisis to the next with stop-gap solutions covering up some serious long term issues, which will have to be dealt with sooner or later.

Throughout this period, markets have been supported by artificially low interest rates and corporate earnings growth, the latter driven in large part by cost cutting and share buybacks, as revenue growth has been harder to come by. Interest rates are unlikely to rise anytime soon, but cracks are appearing in the outlook for corporate profits (as noted by Goldman Sachs, of the 20 S&P 500 companies that have reported earnings this quarter, 18 have reduced their guidance) – not a great sign for markets when valuations appear stretched.

The China Syndrome

China's remarkable growth trajectory over the past decade has been due mainly to rising exports (offshoring of production by companies in the developed world) and massive capital spending on infrastructure and real estate. China's hunger for metals and energy has been a boon to producing nations such as Canada. However, as growth in China decelerates, commodity prices decline. Canadian markets will be impacted negatively if this trend continues.

The chart below tells the story.

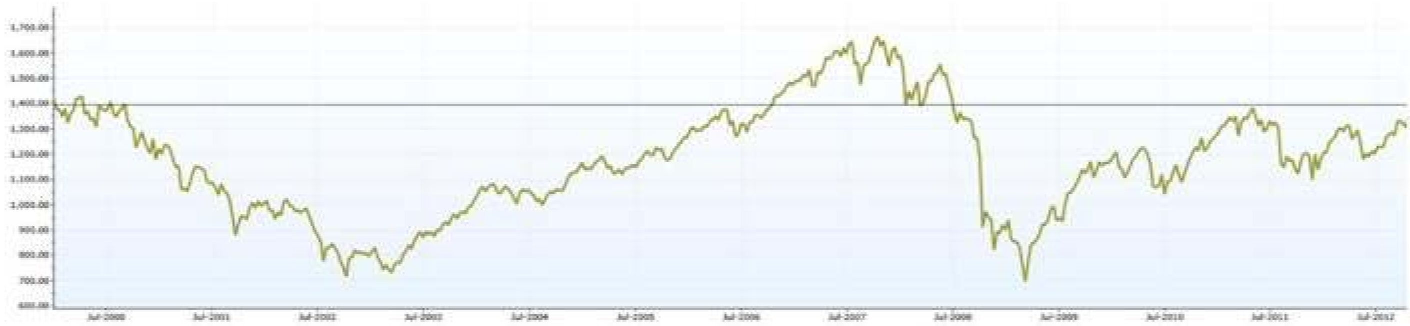
Source: Financial Times, Oct 18, 2012

Value Investing - the case for holding cash

Many investors express a reluctance to hold a significant cash position in their portfolio, as the return is low and there is a perception that the money "is not being put to work". However, there is a misconception about holding cash, one that Warren Buffett debunks perhaps more eloquently than we can. Cash is more than just a safety blanket, it is akin to buying "… a call option with no expiration date, an option on every asset class, with no strike price". **Simply put, by holding cash, we are able to snap up bargains as they arise.** The Globe and Mail recently wrote a great article on Buffett's explanation, which we encourage you to read here: http://www.theglobeandmail.com/globe-investor/investment-ideas/streetwise/for-warren-buffett-the-cash-option-is-priceless/article4565468/

The chart below illustrates that, despite the various market rallies over the past dozen years or so, equity markets have not been kind to those who remained fully invested.

Graph: MSCI Word Index (since 2000)



Source: S&P Capital IQ

The lesson is always the same: buy that which is compellingly cheap and be patient (and hold cash) when the risks outweigh the rewards.

Final Thoughts

"History does not repeat itself, but it does rhyme." - Mark Twain

We are in the midst of a global deleveraging cycle, a process that may take years to play out. The long-term impact of the various policy responses is unknown. Given the elevated risk level, some caution and patience is warranted. As Mark Twain's quote suggests, a look at the past can offer insight into the future. Excessively low interest rates can lead to asset bubbles that eventually burst (dotcoms, housing crisis) and/or an elevated level of inflation, neither of which will be kind to most investors.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

Lorne Steinberg
President